Department of Finance Ministère des Finances

INFORMATION

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DRAFT LEGISLATION ISSUED ON TAX AVOIDANCE INVOLVING CAPITAL DIVIDENDS AND DIVIDEND REFUNDS

The Honourable Michael Wilson, Minister of Finance, announced today his intention to table a Notice of Ways and Means Motion in the House at the earliest opportunity proposing changes to the Income Tax Act to counter two tax avoidance techniques involving dividends of private corporations that are being actively pursued at a potentially substantial revenue cost to the government.

The first of these techniques involves the transfer of the capital dividend accounts of certain private corporations to other corporations for the purpose of sheltering normal dividends and capital gains from tax. The capital dividend account is part of the system for integrating the corporate and shareholder tax of private corporations. This account represents the non-taxable portion of capital gains and certain other non-taxable receipts. A dividend elected to be paid out of a corporation's capital dividend account is not subject to tax in the hands of shareholders.

The second technique involves artificial arrangements to obtain dividend refunds. Such arrangements typically involve the issue of shares by a private corporation to a tax-exempt entity or other shareholder that receives ordinary dividends on a non-taxable basis with the main purpose of enabling the corporation to obtain a dividend refund of its "refundable dividend tax on hand" -- that is, the portion of the tax paid by a private

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corporation on its investment income and capital gains that is repayable to the corporation when it distributes its earnings to shareholders. The dividend refund provisions are also part of the mechanism in the Act for integrating the corporate and shareholder tax on distributed earnings. The arrangements against which the new rules are directed seek to arrange the shareholding in such a way as to avoid the shareholder tax.

The Minister noted that the general anti-avoidance rule proposed as a basis for consultations in the White Paper on Tax Reform was designed to apply to such transactions. He added: "However, it is not clear that present law will be effective in countering the avoidance techniques described above and I am therefore introducing provisions specifically designed to apply to them".

The Minister released the detailed provisions that would be included in the Ways and Means Motion so that all taxpayers would be aware of the proposed changes. The changes will apply with respect to dividends paid after 4 p.m. Eastern Daylight Saving Time, September 25, 1987, the time of the announced changes.

Further information:

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DRAFT LEGISLATION

1.(1) Section 83 of the Income Tax Act is amended by adding thereto, immediately after subsection (2) thereof, the following subsection:

Idem

"(2.1) Where a dividend in respect of which an election under subsection (2) is made is paid on a share of the capital stock of a corporation to a shareholder and the share (or another share for which the share was substituted) was acquired by the shareholder as part of a series of transactions one of the main purposes of which was to obtain a right to the dividend, the amount of the dividend, for the purposes of computing the shareholder's income, shall be deemed to be received by the shareholder as a taxable dividend and not as a dividend that is, by virtue of subsection (2), not included in computing his income."

(2) Subsection (1) is applicable with respect to dividends paid after 4 p.m. Eastern Daylight Saving Time on September 25, 1987.

2.(1) Section 129 of the Income Tax Act is amended by adding thereto, immediately after subsection (1.1) thereof, the following subsection:

Dividends deemed not to be taxable dividends

"(1.2) Where

(a) a dividend is paid on a share of the capital stock of a corporation to a shareholder,

(b) the dividend is included in computing the income of any person who is exempt from tax under section 149 or is a corporation other than a private corporation, and

(c) the share (or another share for which the share was substituted) was acquired by the shareholder,

as part of a series of transactions one of the main purposes of which was to enable the corporation to obtain a dividend refund, for the purpose of subsection (1), the dividend shall be deemed not to be a taxable dividend."

(2) Subsection (1) is applicable with respect to dividends paid after 4 p.m. Eastern Daylight Saving Time on September 25, 1987.